Federal Tax Developments Limited to the Earned Income Tax Credit

Despite the absence of major tax legislation in 1995, some important tax policy developments occurred for rural America. These included the continued phase-in of the expanded earned income tax credit enacted in 1993 and new legislation aimed at improving the targeting of the credit. The large number of tax proposals pending, including the fundamental reform of the Federal income tax, suggests that changes of even greater importance to rural America may be enacted in the near future.

Despite the introduction of a number of new tax initiatives during the year, there were no major tax bills, and only a few minor changes were actually enacted into law in 1995. However, as a result of previous legislation, some significant developments occurred with regard to the earned income tax credit.

The earned income tax credit is a refundable tax credit available to low-income workers who satisfy certain income and eligibility criteria. Most recipients receive the credit in a lump sum at the end of the year by claiming it on their Federal income tax return. Since the credit is refundable, any amount in excess of Federal income and other tax liabilities is used to help the taxpayer offset social security taxes. This refundable portion of the credit is considered a program outlay, while that part used to offset Federal income taxes is considered a tax expenditure. In recent years, about 75 percent of the total credit has been refunded to taxpayers. In fiscal year 1994, based on Federal funds data, the refundable portion of the credit was just over $12 billion. The total value of the credit was $15.7 billion.

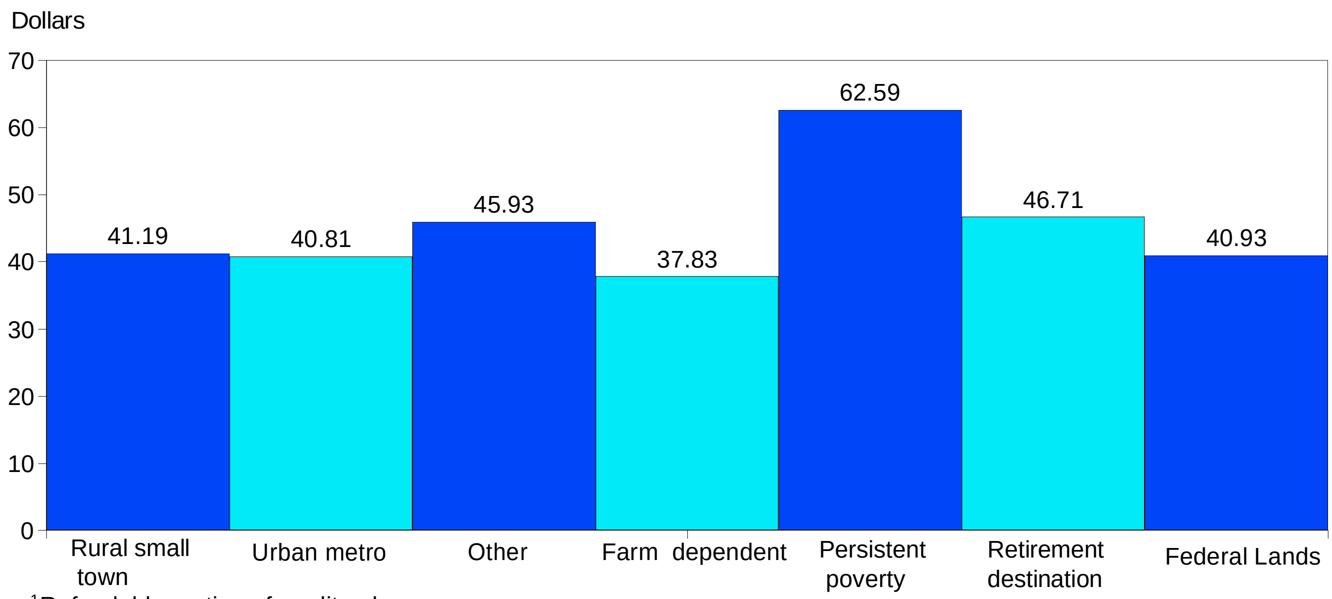
Legislation enacted in 1995 affects eligibility for the earned income tax credit beginning in 1996. Under this legislation, an otherwise qualifying individual will no longer be eligible for the earned income tax credit if the taxpayer has interest, dividend, or net rent or royalty income in excess of $2,350. The primary purpose of this change was to improve the targeting of benefits by denying eligibility to those individuals who may have a relatively low level of earned income but a significant amount of unearned income suggesting some wealth. An estimated 1 to 2 percent of all recipients in 1995 will be ineligible for the credit as a result of this change. However, as many as 10 percent of farmers currently receiving the credit will be disqualified in 1996.

The most significant development with regard to the credit occurred not as a result of legislation enacted in 1995 but because of a 1993 law phased in over a 4-year period.

Figure 1

Per capita earned income tax credit benefits by type of State, fiscal year 1994 [1]

Benefits are largest in persistent-poverty States[2]



[1]Refundable portion of credit only.

[2]See data definitions for State Classifications.

Under the 1993 act, the credit rate for eligible workers with two or more children was increased from 19.5 percent to 40 percent (18.5 to 34 percent for eligible workers with one child). The credit was also expanded to include some low-income workers without children. Thus, both the number of beneficiaries and the level of benefits have significantly increased. For fiscal year 1996, the refundable portion of the credit is expected to increase to $19.1 billion. This represents about 85 percent of the total estimated credit amount of $22.3 billion.

Since the credit is targeted to low-income workers, many of whom are below or near the poverty level, benefits have been the largest in those States identified as persistent-poverty States. Such States received an average per capita benefit in fiscal year 1994 of $62.59 (fig. 1). An additional $19.30 per capita benefit was provided to residents in these States in the form of a Federal income tax offset, resulting in a total per capita benefit of $81.89.

A comparison of rural and urban recipients at the State level is less revealing. In fiscal year 1994, about 16 percent of rural taxpayers received the credit versus only about 12 percent of urban taxpayers. However, per capita benefits in rural States were only slightly higher at $41.19 compared with $40.81 for urban States. This may reflect the overlap between rural and farm-dependent States. Farm-dependent States have the lowest per capita benefit levels at $37.83. This is consistent with the fact that the share of farmers receiving the credit is below that for all taxpayers and only about half that of other rural residents.

Pending Tax Proposals Suggest More Significant Developments in the Future

The large number of tax proposals pending and the delay of action on a number of these during 1995 and 1996 suggest more tax legislation in the future. Both the administration and Congress have proposed significant tax law changes, including a child tax credit, a reduction in capital gains tax rates, education and savings incentives, and additional provisions designed to improve targeting and reduce benefits under the earned income tax credit. Proposals that would completely overhaul the existing Federal income tax system, including a number of flat tax proposals, are also likely to receive some attention. While none of these changes are specifically targeted to rural areas, they could have a significant effect on the tax liabilities and the earned income tax credit benefits of rural residents. *[Ron L. Durst, 202-219-0896, rdurst@econ.ag.gov]*